Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:MCT:WAS:TL-N-358-01
WABaker

date: MAR - 9 2001

to: Team Manager, Team 1131, Fairfax, Virginia (C:LM:FSH)

from: Associate Area Counsel, Washington, D.C. (CC:LM:MCT:WAS)

subject: [redacted]
Protest (Collateral Estoppel)

This is in response to your request dated January 16, 2001 for our comments on the collateral estoppel issue addressed in the Protest filed by the subject consolidated group in response to your 30-day letter. Prior to issuing the 30-day letter, you received written advice from us, dated July 29, 1998, and a field service advice dated October 8, 1998, which were the basis for the position you took in the 30-day letter. For the reasons discussed below, we continue to support the positions taken in the prior advice. However, before discussing the collateral estoppel arguments in the Protest, we will summarize the relevant facts, which are expressed in detail in the prior advice you received.

FACTS:

[redacted] ("[redacted]") was the parent of an affiliated group of corporations that filed consolidated Federal income tax returns for calendar years [redacted] through [redacted]. In [redacted], [redacted] changed its name to [redacted] ("[redacted]").

A notice of deficiency was issued to [redacted], as successor to [redacted], for calendar years [redacted] through [redacted]. In the notice of deficiency, the Commissioner determined that the method of accounting used by [redacted] for [redacted] did not clearly reflect income. I.R.C. §§ 446(b) and 481(a).

[redacted] filed a petition with the U.S. Tax Court. The sole issue for decision was whether the [redacted] received from its [redacted] customers are includable in income in the year received or whether they may be amortized over a 12-month period under Rev. Rroc. 71-21, 1971-2 C.B. 549. The U.S. Tax Court held that the Commissioner had not abused his discretion and that the [redacted] must be included in income in the

year of receipt. [redacted].

On [redacted], while the above action was before the U.S. Tax Court, [redacted] announced plans to spin off substantially all of its [redacted] business as part of an overall reorganization. To facilitate the reorganization, [redacted] caused the incorporation of both [redacted] and [redacted].

On [redacted], [redacted] transferred substantially all of the assets and liabilities of its [redacted] division to [redacted]. At that time, [redacted] was a wholly-owned subsidiary of [redacted], which was a wholly-owned subsidiary of [redacted]. Simultaneously, [redacted] made an initial public offering of approximately [redacted]% of its common stock. On [redacted], [redacted] distributed all of the remaining common stock of [redacted] to [redacted] shareholders. [redacted] is listed on the New York Stock Exchange.

[redacted] and [redacted] commenced business on [redacted]. They reported their taxable income for two short periods ([redacted] through [redacted]; and [redacted] through [redacted]) on the consolidated Federal income tax returns filed by [redacted]. The Service examined those returns and recently issued a 30-day letter to [redacted]. One of the determinations made in that 30-day letter is that [redacted] must include [redacted] received from [redacted] customers in income in the year in which received.

The tax years for which you issued your 30-day letter to [redacted] are the short period begun on [redacted] and ending [redacted], and calendar year [redacted]. In your 30-day letter you also determined that [redacted] must include [redacted] received from [redacted] customers in income in the year in which received.

On [redacted], [redacted] filed an Application for Change in Accounting Method (Form 3115) requesting permission to change its method of accounting for [redacted] received from [redacted] customers beginning with calendar year [redacted]. Question 11 of Part II of Form 3115 asks the following:

> Attach an explanation of the legal basis supporting the proposed change. Including all authority (statutes, regulations, published rulings, court cases, etc.) *supporting the proposed change.* The applicant is encouraged to include a discussion of any authorities

that may be contrary to the proposed change in method of accounting.

[redacted] answered that question as follows:

> In [redacted]), the court concluded that [redacted] income did not fall within the terms of Rev. Proc. 71-21, and therefore [taxpayer] could not defer the [redacted] income over the life of the contract. Permission is requested to change to the method of accounting for [redacted] income consistent with the Internal Revenue Service findings in the [redacted] case.

Attachment to Form 3115, p. 2.

In a letter dated [redacted] from the Assistant Chief Counsel (Financial Institutions & Products), [redacted] was notified that its application could not be processed "because the district director and Taxpayer disagreed on whether Taxpayer was under examination on the date Taxpayer filed the Form 3115." Section 6.01 of Rev. Proc. 97-27, 1997-1 C.B. 680. In the letter, [redacted] was informed that the issue of whether it was under examination on the date it filed its Form 3115 could be referred to the national office for technical advice.

Subsequently, at a technical advice request pre-submission conference at the national office, [redacted] was reminded that under section 8.01 of Rev. Proc. 97-27 the Service reserves the right to decline to process any application for change in accounting method in which it would not be in the best interest of sound tax administration to permit the requested change. There was also a discussion about the U.S. Tax Court's holding in Capital Federal Savings & Loan Ass'n v. Commissioner, 96 T.C. 204 (1991), sustaining the Service's refusal to consider a taxpayer's application for change in method of accounting. After the pre-submission conference, [redacted]'s representatives notified you that they did not want to proceed with technical advice on the issue of whether the consolidated group was under examination at the time [redacted] filed the application for change in method of accounting.

DISCUSSION:

[redacted] received from [redacted] customers are includable in income in the year received; they may not be amortized over a 12-month period under Rev. Proc. 71-21. [redacted]

[redacted]. In its application for change in method of accounting, [redacted] concedes this fact. There is no argument to the contrary in the protest filed by [redacted]. Therefore, [redacted]'s method of accounting must be changed because it does not clearly reflect its income. I.R.C. § 446(b).

The dispute with [redacted] is merely the year of change. We are still of the opinion that [redacted] should use the proper method of accounting beginning with its short tax-year begun [redacted] and ended [redacted]. [redacted] wants to postpone the change until calendar year [redacted].

In prior advice you received on this issue, we concluded that the doctrine of collateral estoppel will prevent [redacted] from re-litigating the accounting method issue. We will not repeat that argument here; however, the essence of our conclusion is that we believe the Service has no litigating hazard on the accounting method issue. Further, we do not believe the Service abused its discretion when it refused to grant [redacted] a change in method of accounting beginning in calendar year [redacted].

In its Protest, [redacted] presents four arguments for the inapplicability of the doctrine of collateral estoppel. Those arguments, and our responses to them, are as follows.

1. Collateral estoppel is inapplicable in the absence of mutuality of parties. Protest, pp. 8-9.

The general rule is that mutuality of parties is not required to apply collateral estoppel; however, an exception to the general rule is that mutuality is required to apply collateral estoppel against the United States. United States v. Mendoza, 464 U.S. 154 (1984); United States v. Stauffer Chemical Co., 464 U.S. 165 (1984); Parklane Hosiery Co. v. Shore, 439 U.S. 322 (1979). The reason for the exception is that the United States is far more likely than any private litigant to be involved in suits against different parties with the same legal issue.

2. [redacted] did not have a full and fair opportunity to present its arguments with respect to the issue. Protest, p. 9.

[redacted], [redacted]'s parent, did have a full and fair opportunity to litigate the issue. After a trial on the merits in the prior case, the U.S. Tax Court issued an opinion against the taxpayer. The taxpayer appealed to the Court of Appeals for the Fourth Circuit, which affirmed the U.S. Tax Court.

Therefore, [redacted] is precluded from litigating the issue again. The legal basis for this conclusion is discussed in the prior advice you received and will not be repeated here.

3. This is in not the kind of issue in which the collateral estoppel doctrine should be applied. Protest, p. 10.

As discussed in the prior advice you received, we believe that this is exactly the kind of case to which the doctrine of collateral estoppel applies. See e.g. Peck v. Commissioner, 90 T.C. 162 (1988), aff'd, 904 F.2d 525 (9th Cir. 1990)(interpretation of same lease terms); Hibernia National Bank v. United States, 740 F.2d 382 (5th Cir. 1984)(interpretation of lease for which only minor, irrelevant revisions had been made); McMullan v. United States, 686 F.2d 915, 918-20 (Ct. Cl. 1982)(character of gain on continuing sale of timber property); Jones v. United States, 466 F.2d 131 (10th Cir 1972)(payment under single contract); Union Bag-Camp Paper Corp. v. United States, 366 F.2d 1011 (Ct. Cl. 1966)(rent payments on contract); Your Host, Inc. v. United States, 81-1 USTC ¶ 9261, 47 AFTR2d 1393 (WDNY 1980)(application of § 482 based on taxpayer's admission that business operations between related corporations were unchanged from prior years).

4. [redacted] has access to different courts that those that handed down the decision upon which the Service relies. Protest, p. 10.

Taxpayer's argument is irrelevant and meritless. Although the taxpayer could take this matter to a court other than the U.S. Tax Court, collateral estoppel would operate to bar re-litigation of any issue previously litigated by a court of competent jurisdiction. Montana v. United States, 440 U.S. 147, 153-54, 162 (1979); Monahan v. Commissioner, 109 T.C. 235 (1997), *aff'd*, 86 F.3d 1162 (9th Cir. 1996). See also Restatement Judgments 2d (1982), § 17, comments c and d. The Tax Court and the Fourth Circuit had jurisdiction over the matters at issue in [redacted], supra, thus any "forum shopping" for a different result would be a fruitless endeavor.

CONCLUSION:

[redacted] must include [redacted] received from [redacted] customers in income in the year in which the [redacted] are received for every tax year since it commenced business, beginning with the short period begun on [redacted] through [redacted]. We also suggest a change to your 30-day letter to note the following: (1) [redacted]'s method of accounting was changed beginning with its short period begun

on [redacted] through [redacted]; and, (2) the adjustments in the revenue agent's report are required to keep it on that method of accounting. I.R.C. § 446.

If you have a question, please contact Special Litigation Assistant Wilton A. Baker. His telephone number is (202) 634-5403, ext. 269.

BETTIE N. RICCA
Associate Area Counsel (LMSB)